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An Audit Report on

# **Procurement at the Texas Lottery Commission**

August 2006  
Report No. 06-062



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***Procurement at the Texas Lottery  
Commission***

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## ***Overall Conclusion***

The Texas Lottery Commission (Agency) has contracting policies and procedures that address all five contracting phases in the Texas Building and Procurement Commission's *State of Texas Contract Management Guide*. These policies and procedures establish a sound baseline for the Agency's contracting and procurement processes. As a result, the Agency effectively evaluates and selects its contractors, and its contracts include provisions required by statutes.

However, the Agency should make improvements in certain areas. The Agency:

- Did not deduct \$148,000 in sanctions and liquidated damages from its payments to the primary lottery operator. This amount was relatively small and represented less than one percent of the contract's total amount.
- Made \$287,000 in potential overpayments to an advertising contractor. Those were potential overpayments because they were not made in accordance with the terms of the contract. This amount represents less than 1 percent of the contract's total amount and 14 percent of the contractor's total commissions.
- Does not consistently document its needs and perform risk assessments when planning its contracts. The Agency did not assess its needs and risks for five of seven contracts that auditors tested for contract planning.
- Does not have a standard contract negotiation process and did not conduct or document negotiations for two of six contracts that auditors tested for negotiations.
- Has weaknesses in its administration of contracts in areas such as contract monitoring and evaluation of contract amendments.

**Contracting Phases in the  
Texas Building and Procurement  
Commission's  
*State of Texas Contract  
Management Guide***

- Planning
- Procurement
- Contract formation
- Rate/price establishment
- Contract administration

**Agency Contracting Information**

In fiscal year 2005, the Agency was appropriated \$177,624,054. That year, its payments to contractors totaled \$111,989,075, which represented 63 percent of the Agency's fiscal year 2005 appropriations.

In fiscal year 2006, the Agency was appropriated \$199,862,412. The amounts of the contracts that auditors tested during this audit totaled \$132,806,791, which represented 66 percent of the Agency's fiscal year 2006 appropriations.

These issues increase the risk that the Agency's contracts may not completely address its needs and that the Agency may not be paying the most favorable rates for its contracts.

## **Key Points**

**The Agency should take additional steps to promote competition for its contracts.**

The Agency should make it a priority to maximize competition for its contracts (as required by Texas Government Code, Section 466.101) by taking advantage of opportunities to increase the number of qualified bidders. Specifically:

- The Agency does not always receive at least three bids or document the reasons it receives few bids, as required by Title 16, Texas Administrative Code, Section 401.101 (b). The Agency received only one bid each for two contract solicitations auditors reviewed, and it did not document an explanation for the lack of competition or contact potential vendors that had not bid.
- The Agency did not document its justification for the minimum qualifications required of its bidders for three contract solicitations, which indicates there is a risk that minimum qualifications were unduly restrictive and, therefore, potentially limited competition.

In the absence of multiple qualified bidders, the Agency cannot determine the market value of its contracts, ensure that it procures the highest quality goods or services, or ensure that it pays the most competitive prices.

**The Agency should improve its monitoring of the primary lottery operator.**

The Agency should improve its monitoring of the primary lottery operator to identify noncompliance with the contract more promptly. For example, the primary lottery operator provides performance reports to the Agency, but the Agency does not independently verify the information in those reports in a timely manner. The reports list sanctions and liquidated damages associated with instances of contract noncompliance the primary lottery operator has identified. (Sanctions and liquidated damages can be assessed for a variety of events, such as when online games are unavailable or when the lottery system produces inaccurate vendor terminal reports.)

The Agency receives verification of the primary lottery operator's performance reports only through external audits. This could allow instances of noncompliance to go undetected for up to three months, and problems with the accuracy of the primary lottery operator's reports may not be detected for as long as one year. Because of the critical nature of the goods and services provided through the primary lottery operator's contract, this level of assurance should be improved.

**The Agency's purchases are necessary and reasonable, but the Agency should strengthen controls over its automated purchasing system.**

We reviewed 54 purchases the Agency made between December 2004 and May 2006 and determined that they were necessary and reasonable. However, the Agency did not fully comply with its rules, policies, and procedures for nine (16.67 percent) of these purchases. Those nine purchases totaled \$174,113 (2.13 percent of the purchase amounts tested). Most instances of noncompliance with rules, policies, and procedures that auditors identified were minor in nature. The Agency lacked documentation explaining the need for only 3 of the 54 purchases tested (these 3 represented 1.37 percent of the purchase amounts tested).

Although auditors did not identify significant errors in the Agency's purchases, access to the Agency's automated purchasing system is not adequately restricted. As a result, the Agency cannot ensure that all purchases are initiated and approved by the appropriate employee.

### ***Summary of Significant Recommendations***

The Agency should:

- Improve its planning process for contracts.
- Strengthen its monitoring process for contracts.
- Establish a standard contract negotiation process.

The Legislature should consider amending Texas Government Code, Section 466.105, to remove the Agency's exemptions from contracting statutes.

### ***Summary of Management's Response***

The Agency agrees with the recommendations in this report.

### ***Summary of Information Technology Review***

The Agency uses multiple information systems for its contracting operations. This audit included a review of the Agency's purchasing system and the Agency's Contract Management Database.

Our review focused on access to these systems and controls that are applicable to the Agency's processing of contracts and purchases. These systems have significant weaknesses in access, segregation of duties, and initiation and approval of transactions by appropriate employees.

## ***Summary of Objectives, Scope, and Methodology***

The objectives of this audit were to determine:

- Whether purchases are necessary and reasonable and made in accordance with state laws and regulations and Agency rules, policies, and procedures.
- Whether the Agency manages selected contracts to ensure that the contracts are monitored and the terms of these contracts are enforced.
- The status of findings and recommendations related to Agency contracts reported by the State Auditor's Office in *An Audit Report on Management Controls at the Texas Lottery Commission*, SAO Report Number 97-092, August 1997.

The audit scope covered Agency non-contract purchases from December 2004 through May 2006 and the Agency's contracts, controls, and contracting process as of May 2006.

The audit methodology included collecting information and documentation, performing selected tests and other procedures, analyzing and evaluating the results of the tests, and conducting interviews with Agency management and staff. Each aspect of contract management that auditors tested was tested with a different sample of contracts.

Recent SAO Work		
Number	Product Name	Release Date
06-047	An Audit Report on Workforce Management at the Texas Lottery Commission	July 2006
06-046	An Audit Report on Lotto Texas Activities at the Texas Lottery Commission	July 2006
06-035	An Audit Report on Security at the Texas Lottery Commission	May 2006
06-017	A Report on an Audit of the Texas Lottery Commission's Annual Financial Report for the Fiscal Year Ended August 31, 2005	December 2005
04-046	An Audit Report on Selected Controls Over Instant Tickets at the Texas Lottery Commission	August 2004

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# Detailed Results

Chapter 1

## The Agency Should Improve Its Contract Management Process

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The Texas Lottery Commission's (Agency) policies and procedures address all five contracting phases discussed in the Texas Building and Procurement Commission's *State of Texas Contract Management Guide* (see text box for a description of the five phases). When the Agency is able to solicit multiple bids for its contract solicitations, its processes help it evaluate and select the most qualified contractors. However, because the Agency is not always able to solicit three or more bids for its contracts, it should improve how it plans its contract solicitations and establishes rates and prices for its contracts.

### Contracting Phases

The Texas Building and Procurement Commission's *State of Texas Contract Management Guide* offers state agency contract managers recommendations on improving contract management processes and practices.

This guide outlines five major phases of the contracting process:

- **Planning** - Identify contracting objectives and contracting strategy.
- **Procurement** - Fairly and objectively select the most qualified contractors.
- **Contract formation** - Ensure the contract contains provisions that hold the contractor accountable for producing desired results.
- **Rate/price establishment** - Establish processes that are cost-effective and aligned with the cost of providing the goods and services.
- **Contract administration** - Monitor and enforce the terms of the contract, including:
  - ♦ Monitoring
  - ♦ Enforcement
  - ♦ Payment
  - ♦ Change management

In addition, the Agency has not implemented all prior recommendations from *An Audit Report on Management Controls at the Texas Lottery Commission*, SAO Report Number 97-092, August 1997. Of the eight prior audit recommendations that we reviewed, three are now implemented, three are incomplete or ongoing, one is not implemented, and one is no longer applicable to the Agency's operations. Additional details regarding the Agency's implementation of prior audit recommendations are located in Appendix 2.

**Contract Planning:** The Agency does not consistently assess its needs and perform risk assessments when planning its contracts.

Of the seven contracts tested for the adequacy of the needs and risk assessment, five did not include an analysis of the Agency's needs or risks. The Agency's policies require it to perform a cost-benefit analysis to identify its contracting options, and feasibility of proposals. However, these

policies do not require the Agency to assess its needs and risks as recommended by the Texas Building and Procurement Commission's *State of Texas Contract Management Guide*. Two of the five contracts noted above were awarded prior to the Agency's adoption of procedures requiring cost-benefit analyses; however, the analysis of needs and risks is an essential step in developing contracts that appropriately address all requirements.

Without developing complete needs and risks documentation in contract planning, subsequent steps in the contracting process may not ensure that contracts address the Agency's needs. As a result:

- Two of eight contracts tested for the adequacy of contract terms lacked a clear statement of work. Without a clear statement of work, the Agency's ability to effectively monitor its contracts is limited.
- Auditors tested six contracts for evidence of negotiations and determined that two of the contracts did not have documentation of negotiations. Without negotiations, the Agency might not have considered essential contract terms and conditions.

The Agency should take additional steps to maximize competition for its contracts.

**Texas Government Code,  
Section 466.101 (a)**

The executive director may establish procedures for the purchase or lease of facilities, goods, and services and make any purchases, leases, or contracts that are necessary for carrying out the purposes of this chapter. The procedures must, as determined feasible and appropriate by the executive director, **promote competition to the maximum extent possible.** (Emphasis added)

**Excerpts from Title 16,  
Texas Administrative Code,  
Section 401.101 (b)**

(2) For the purchase or lease of goods and services not expected to exceed \$25,000, the commission, at a minimum, must conduct an informal competitive solicitation in an attempt to obtain at least three competitive price quotations.

(3) For the purchase or lease of goods and services expected to exceed \$25,000, the commission must conduct a formal competitive solicitation in an attempt to obtain at least three competitive bids or proposals.

(5) For those formal or informal competitive solicitations where less than three bids, proposals, or price quotations are received, the commission must document the reasons, if known, for the lack of three bids, proposals, or price quotations. If less than three bids, proposals, or price quotations are received, the commission may cancel the solicitation and conduct another solicitation, or it may award a contract if one acceptable bid, proposal, or price quotation is received.

The Agency should make it a priority to maximize competition for its contracts by taking advantage of opportunities to increase the number of qualified bidders. Texas Government Code, Section 466.101 (a), requires that any contracting process promote competition to the maximum extent possible (see text box). The following practices hinder competition for the Agency's contracts:

- The Agency does not always receive at least three responses to its competitive solicitations or document the reasons it receives few responses, as required by Title 16, Texas Administrative Code, Section 401.101 (b) (see text box). Auditors reviewed six of the Agency's contract solicitations. For two of these contract solicitations, the Agency received only one bid and did not document an explanation for the lack of competition or contact potential vendors that had not bid. For one contract solicitation, the Agency received two bids and, as required by statute, contacted potential vendors that did not submit bids. The Agency received bids from at least three qualified bidders for three other contract solicitations. In the absence of multiple qualified bidders, the Agency cannot determine the market value of its contracts, ensure that it procures the highest quality goods or services, or ensure that it pays the most competitive prices.
- Auditors reviewed three contract solicitations to ensure that the minimum requirements were not unduly restrictive and found that the Agency did not document justification for the minimum qualifications required of its bidders. For two of these contract solicitations, the Agency received one bid each, indicating there is a risk

that the minimum qualifications were unduly restrictive, therefore, potentially limiting competition.



- The Agency does not have procedures for identifying the essential terms and conditions that it will negotiate to ensure successful contract performance. The Texas Building and Procurement Commission's *State of Texas Contract Management Guide* recommends that agencies identify the terms and conditions that are essential, desirable, and subject to negotiation or relinquishment. Not identifying terms that the Agency considers essential to a contract increases the risk that a contract will not achieve the Agency's desired results. Auditors reviewed six contracts for sufficiency of negotiations. The Agency did not negotiate two of these contracts.

## Recommendations

The Agency should improve its planning process for contracts by doing the following:

- Consistently perform and document needs and risk assessments for all future contracts, regardless of whether a cost-benefit analysis is performed in conjunction with needs and risk assessment.
- Use its needs and risk assessment to develop a clear and thorough statement of work to include in each contract.
- For future contracts, assess and document the reasons that it receives fewer than three bids. The Agency should analyze this information to determine whether its contracting process should be modified.
- Determine and document the minimum acceptable qualifications for future contract solicitations based on objective criteria that it can subsequently use during contract monitoring, renewal, and re-bidding.
- Develop written policies and procedures for negotiation with contractors to ensure that it identifies the contract terms and conditions that are essential to its needs, and focus its negotiation efforts on these terms and conditions for future contracts.

## Management's Response

*Management agrees with the recommendations:*

- *The agency will update the Cost Benefit Analysis (CBA) procedure to incorporate a requirement for needs and risk assessments for all future contracts. The procedure will be updated by November 1, 2006.*
- *Information identified as part of the revised CBA procedure, including the needs and risk assessments, will be used to develop the statement of work for each contract.*

- *The agency developed and implemented a Single Bid Response Inquiry and Justification procedure on August 8, 2006 which outlines how solicitations with fewer than three bids will be processed.*
- *The Agency will ensure that minimum acceptable qualifications are developed for each contract solicitation prior to its release. In the event a solicitation results in fewer than three bids, the agency will contact prospective bidders to determine if the qualifications were prohibitive and document the procurement file as appropriate. This approach is outlined in the Single Bid Response Inquiry and Justification procedure.*
- *The agency has drafted a new procedure based on the Texas Building and Procurement Commission (TBPC) Contract Management Guide that outlines a standard process for negotiating contracts. The procedure will be implemented by September 15, 2006.*

**Contract Procurement:** The Agency effectively evaluates and selects its contractors.

Although the Agency did not always plan for its contracts effectively; it has a strong evaluation and selection process for the bids it receives. When the Agency is able to attract more than three bidders, this process helps the Agency to ensure that it selects the bidder that offers the best value for the contracted goods and services. Table 1 shows the strengths of the Agency's evaluation and selection process.

Table 1

The Evaluation and Selection Process for Six Contracts				
Contractor and contract number	Number of bids the Agency received	Did the Agency use an evaluation committee?	Did the winning bidder meet minimum qualifications?	Did the Agency complete bidder evaluation?
DDB Dallas (03-0230)	4	Yes	Yes	Yes
M&S Works, Inc. (06-9144)	1	Yes	Yes	Yes
Plugged-In (05-9128)	2	Yes	Yes	Yes
Pollard Banknote Limited (05-9126)	4	Yes	Yes	Yes
Randall Eubank (04-9148)	1	Yes	Yes	Yes
Scientific Games International (05-9125)	4	Yes	Yes	Yes
Note: See Appendix 3 of this report for a description of the goods and services provided through each contract, contract amounts, and contract periods.				

Source: State Auditor's Office's analysis of evaluation and selection process for six contracts.

For each of the six contracts auditors tested for the adequacy of the evaluation and selection criteria, the Agency complied with its policies and procedures for evaluating and selecting the winning bidder. Additional review of three contracts indicated that the Agency accurately scored bidder proposals using quantifiable best value criteria. This provides assurance that the Agency can support its decision to select the winning bidder in the event that other competing bidders dispute the Agency's decision.

**Contract Formation:** The Agency's contracts include provisions required by statutes.

Auditors reviewed contract provisions in eight contracts for compliance with statutory requirements and identified no significant omissions. The Agency performed appropriate legal review for each of these contracts before the contract solicitation was issued. In addition, the Agency included terms and conditions in its contracts that addressed statutory requirements and protected the State's interests. Table 2 summarizes the statutory requirements that auditors tested.

Table 2

Statutorily Required Provisions in Eight Contracts			
Contractor and contract number	Texas Government Code		
	Section 466.102 requires provisions for liquidated damages and performance bonds	Section 2261.101 requires a schedule for remedies and sanctions	Section 2261.102 requires contractors to obtain liability insurance
	Did contract comply with statutory requirement?		
Davila, Buschhorn & Associates, P.C. (04-9115)	Yes	Yes	Yes
DDB Dallas (03-0230)	Yes	Yes	Yes
Graves, Dougherty, Hearon, & Moody (06-9189)	Yes	Yes	Yes
GTECH Corporation (02-291)	Yes	Yes	Yes
M&S Works (06-9144)	Yes	Yes	Yes
Pollard Banknote Limited (05-9126)	Yes	Yes	Yes
Randall Eubank (04-9148)	Yes	Yes	Not Applicable
Scientific Games International (05-9125)	Yes	Yes	Yes

Source: State Auditor's Office's analysis of the provisions in eight contracts.

It is important to note that the Texas Government Code, Section 466.105, exempts the Agency from certain statutes related to contracting (see Appendix 4). However, the Agency makes an effort to voluntarily implement many of those requirements, which helps it ensure that its contracts protect the State's interests.

Although the Agency complies with statutory requirements, it did not include a detailed description of work to be performed in two contracts as recommended by the Texas Building and Procurement Commission's *State of Texas Contract Management Guide*. Specifically:

- The Agency contracted for legal services but did not describe the nature or scope of work to be performed by the contractor in the contract terms or the contract solicitation.
- The Agency's contract with the primary lottery operator does not clearly define the content of all deliverables. The primary lottery operator has

hired an outside firm to assist the Agency in determining the usefulness of deliverables the primary lottery operator currently provides.

Without developing a clear statement of work, the Agency is not able to ensure that contract terms result in desired contractor performance.

### Recommendations

The Agency should ensure that its contract solicitations and resulting contracts always include a clearly communicated statement of work that defines the goods and services the contractor will provide.

The Legislature should consider amending Texas Government Code, Section 466.105 to remove the Agency's exemptions from contracting statutes.

### Management's Response

*Management agrees with the recommendation. Information identified as part of the revised CBA procedure, including the needs and risk assessments, will be used to develop a clear statement of work for each contract solicitation.*

*The agency supports this recommendation and will ensure the Commission is fully briefed regarding this issue.*

**Rate/Price Establishment:** The Agency does not have a standard contract negotiations process.

Auditors reviewed six contracts and found no evidence that the Agency had negotiated two of them. The Agency has no policies and procedures for its negotiations process. For example, it does not have policies and procedures that specify when it should enter into negotiations and how it can evaluate offers it receives during negotiations to ensure they meet the terms it deems essential to contractor performance. Because of this, the Agency awarded two contracts based on the contractor's cost proposal in each bid without any negotiation.

Table 3 summarizes the contracts that auditors tested for negotiations.

Table 3

Negotiations for Six Contracts			
Contractor and contract Number	Year Contract Awarded	Contract Value for Fiscal Year 2006	Did the Agency perform and document contract negotiations?
DDB Dallas (03-0230)	2003	\$32,000,000	No
M&S Works (06-9144)	2006	\$1,464,636	Yes
Plugged-In (05-9128)	2005	\$36,399	Not applicable <sup>a</sup>
Pollard Banknote Limited (05-9126)	2005	\$4,900,000	Yes
Randall Eubank (04-9148)	2004	\$143,000	No
Scientific Games International (05-9125)	2005	\$11,300,000	Yes
<sup>a</sup> Negotiations were not performed because this contract was a request for quote. See Appendix 3 of this report for a description of the goods and services provided through each contract and contract periods.			

Source: State Auditor's Office's analysis of negotiations for six contracts.

As a result of these weaknesses, the Agency may not be able to determine whether the price and other contract terms are the most favorable.

### Recommendations

The Agency should:

- Develop and implement policies and procedures that address when it should enter into negotiations with contractors.
- Ensure that the essential and desirable terms and conditions identified in the planning for each contract are included in the Agency's negotiations.
- Use the cost-benefit analysis developed in planning as a basis from which it can negotiate rates with its contractors.

## Management's Response

*Management agrees with the recommendations.*

- *The agency has drafted a new procedure based on TBPC's Contract Management Guide that outlines a standard process for negotiating contracts.*
- *The agency's new procedure on negotiating contracts will ensure desirable terms and conditions are identified and included as part of all contract negotiations.*
- *The agency's new procedure on negotiating contracts will outline the process for utilizing the cost benefit analysis developed for the contract solicitation as part of the basis for contract rate negotiation.*
- *The new procedure for negotiating contracts will be implemented by September 15, 2006.*

**Contract Administration:** The Agency should improve the administration of its contracts.

The Agency should improve how it administers its contracts to ensure that its needs are addressed. Auditors reviewed the four components of the administration phase of the Texas Building and Procurement Commission's *State of Texas Contract Management Guide*—monitoring, enforcement, payment, and change management—and determined that the Agency:

- Has weaknesses in its monitoring of the primary lottery operator.
- Did not collect \$148,000 in liquidated damages and sanctions from its primary lottery operator.
- Did not identify a \$287,000 potential overpayment it made to its advertising contractor.
- Does not have a standard process for certain contract administration activities.

### Significant External Audit Reports the Agency Receives from the Primary Lottery Operator

- The primary lottery operator's external auditor conducts a quarterly contract compliance review to determine whether the lottery operator is in compliance with all the contract deliverables.
- The primary lottery operator's external auditor conducts audits in accordance with the American Institute of Certified Public Accountants' Statements on Auditing Standards No. 70 every year to determine whether contractor-generated reports are reasonably accurate.

The Agency has weaknesses in its monitoring of the primary lottery operator. The Agency's monitoring of its primary lottery operator is not adequate to identify issues of noncompliance in a timely manner. The main monitoring tools that the Agency uses are periodic external audits (see text box) and self-reported information from the primary lottery operator. The agency assesses sanctions using self-reported information provided by the primary lottery

operator, but it does not routinely verify this information. Instances of noncompliance could go undetected for up to three months, and problems with the accuracy of the primary lottery operator's reports may not be discovered for as long as one year. Because of the critical nature of the goods and services provided through the primary lottery operator's contract, this level of assurance is not adequate.

The Agency relies on the primary lottery operator's assertion that it tests its back-up data center (which would ensure continued operation of the online games if the primary system failed), but the Agency does not periodically verify that these tests are successfully executed. The Agency receives some assurances that the back-up data center is functional from a biennial security review (see *An Audit Report on Security at the Texas Lottery Commission*, State Auditor's Office Report No. 06-035, May 2006). However, if the Agency periodically verified that the back-up data center was operational, it would have more timely assurance that online games would not be affected if the primary lottery operator's primary system failed.

The Agency does not always pay its contractors in accordance with contract terms. From May 2005 to May 2006, the Agency potentially overpaid its advertising contractor an estimated \$287,000 when compared to the terms of its contract. This occurred because the Agency paid the contractor commissions on an amount that was higher than the amount the contractor actually billed the Agency. This payment methodology is based on industry standards that are not stated in the contract. The Agency did not identify this discrepancy during the formation of the contract. The Agency has not amended this contract and is still paying the contractor the higher commissions.

From June 2005 to June 2006, the Agency applied \$641,630 in sanctions and liquidated damages but it did not deduct one sanction of \$148,000 from payments to the primary lottery operator as required by the terms of the primary lottery operator contract. As a result of the State Auditor's Office's audit, the Agency has taken action to assess and collect these sanctions and liquidated damages from the primary lottery operator. The Agency's ability to verify sanctions and liquidated damages is limited because the information is self-reported by the primary lottery operator and the Agency does not routinely verify it. Additionally, the Agency does not always reference the detailed descriptions of each sanction or liquidated damage back to the contract when it makes deductions from its payments to the primary lottery operator.

These weaknesses could lead the Agency to assess the wrong sanctions and liquidated damages or lead to the contractor's contesting sanctions and liquidated damages that the Agency imposes.



The Agency does not have a standard process for certain contract administration activities. The Agency does not monitor its payment rates or methods as required by Texas Government Code, Section 2261.151 (a) (see text box). The Agency's inability to comply with this statute creates a significant risk that it is not paying rates that are competitive with market rates. The Agency obtains many goods and services through contracts. In many instances, the Agency is faced with (1) extending its existing contract or (2) initiating a new contract solicitation. When it faces these options, the Agency is not able to determine whether it could obtain a more favorable rate if it initiated a new contract solicitation because it does not monitor the rates and payment terms for its contracts as required by this statute.

**Texas Government Code,  
Section 2261.151 (a)**

To ensure that its payment and reimbursement methods and rates are appropriate, each state agency that makes procurements to which this chapter applies shall reevaluate at least biennially its payment and reimbursement methods and rates, especially methods and rates based on historical funding levels or on a formula established by agency rule rather than being based on reasonable and necessary actual costs incurred.

The Agency does not ensure that it monitors the contracts and deliverables that present the most risk because it does not perform a risk assessment to focus its contract monitoring efforts. The Texas Building and Procurement Commission's *State of Texas Contract Management Guide* recommends that agencies identify contracts and contract deliverables that should involve a significant degree of oversight. An effective risk assessment should help focus monitoring resources on contract deliverables with the highest risk of noncompliance with contract terms.

The Agency does not have formal policies and procedures for modifying the terms of existing contracts or evaluating the effect of contract changes. Auditors reviewed nine amendments to two contracts and determined that the Agency did not evaluate these amendments for their financial impact prior to signing them. Failure to manage and control changes to its contracts can result in the Agency's unintentional modification of the scope of work, contract cost, and contractor accountability.

The Agency's Contract Management Database does not have adequate automated controls. The Agency's Contract Management Database does not have adequate automated controls to prevent unauthorized changes to data or to identify changes that specific users make. The impact of these weaknesses is limited because only two users access the Contract Management Database. However, because this system is primarily used for contract enforcement, these weaknesses limit the Agency's ability to rely on automated data for its enforcement activities.

## Recommendations

The Agency should:

- Strengthen its monitoring efforts for the primary lottery operator contract to ensure compliance with contract terms.
- Periodically verify that the primary lottery operator's back-up data center is operational.
- Ensure that it (1) assesses and collects all sanctions and liquidated damages in a timely manner and (2) that it clearly references sanctions and liquidated damages back to the contract when it makes deductions from contractor payments.
- Pay contractors in accordance with the existing terms of its contracts or amend the contracts based on agreements with the contractors.
- Establish formal policies and procedures for modifying its contracts.
- Ensure that it thoroughly evaluates all contract amendments prior to their adoption. This evaluation should include review of amendments' financial and operational impact.
- Implement controls in its Contract Management Database that prevent unauthorized changes and allow it to track user changes to this system.

## Management's Response

*Management agrees with the recommendations:*

- *The agency has worked with a third party vendor (Protiviti) to conduct a thorough risk assessment of the lottery operator contract and develop a comprehensive contract compliance schedule. Protiviti has initiated compliance monitoring and will issue quarterly compliance reports beginning in September 2006.*
- *The lottery operator's back-up data center will be tested quarterly regarding operational readiness as part of the Protiviti compliance review. The results of the first test will be provided in the September 2006 report.*
- *The agency will ensure that all contract sanctions and liquidated damages are enforced and collected in a timely manner. When assessing sanctions and liquidated damages, the appropriate contract citation will be referenced.*

- *The agency will ensure that invoice payments are reviewed and approved in accordance with the existing terms of its contracts. In the event that ambiguous contract terms are discovered, as in the case of the advertising contract identified in the audit, the agency will ensure that such terms are clarified.*
- *The agency will develop a procedure for modifying its contracts. The procedure will be implemented by November 1, 2006.*
- *The agency will update the Cost Benefit Analysis procedure requiring a thorough analysis and review of all contract amendments prior to adoption. The procedure will be updated by November 1, 2006.*
- *The Contract Management Database is currently being re-engineered. Access will be controlled and monitored through discrete user sign-on identifications allowing only those with proper access authority to make changes. The new database will be implemented by April 1, 2007.*

## ***The Agency's Purchases Are Necessary and Reasonable, But the Agency Should Strengthen Controls Over Its Automated Purchasing System***

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Auditors tested 54 purchases totaling \$8,165,000 that the Agency made between December 2004 and May 2006.<sup>1</sup> We determined that these purchases were necessary and reasonable.

However, the Agency did not fully comply with its rules, policies, and procedures for nine (16.67 percent) of these purchases. Those nine purchases totaled \$174,113 (2.13 percent of the purchase amounts tested). Most instances of noncompliance with rules, policies, and procedures that auditors identified were minor in nature. The Agency lacked documentation explaining the need for only 3 of the 54 purchases tested (these 3 represented 1.37 percent of the purchase amounts tested).

### **The Agency's Purchasing System**

The Agency's purchasing system has two components:

- The eRequisition component, which updates the Agency's accounting system. eRequisition contains all of the justifications and approvals for purchases.
- Great Plains, the Agency's accounting system, which creates purchase orders.

For purposes of this report, references to the Agency's "purchasing system" include both the eRequisition component and Great Plains.

Although auditors did not identify significant errors in the Agency's purchases, access to the Agency's automated purchasing system is not adequately restricted. As a result, the Agency cannot ensure that all purchases are initiated and approved by the appropriate employee. The purchasing system has the following weaknesses:

- Password administration issues could allow unauthorized access to the system.
- Designated employees are allowed to use other employees' user IDs to access the purchasing system. This does not allow for the creation of an accurate record of purchase approvals.
- The purchasing system administrator also uses the system to make purchases. This weakness in segregation of duties increases the risk that unauthorized purchases could be made.

### **Recommendations**

The Agency should:

- Ensure that it has appropriate justification for all purchases it makes.
- Ensure that employees consistently comply with the Agency's purchasing policies and procedures.

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<sup>1</sup> The 54 purchases auditors reviewed included some purchases for which the Agency had not yet paid the vendor.

- Strengthen its password administration function.
- Require users to access the purchasing system using their own user IDs and passwords. It should not allow employees to use other employees' user IDs and passwords.
- Restrict the system administrator's access to initiate purchase requests in the purchasing system.

### Management's Response

*Management agrees with the recommendations:*

- *The Agency will ensure that it has appropriate justification for all purchases it makes.*
- *The Agency will ensure that employees consistently comply with the Agency's purchasing policies and procedures.*
- *Current system constraints limit password administration to the system administrator. The Agency is currently evaluating a new electronic requisition system that provides for stronger password administration.*
- *Current system constraints limit the approval process for electronic requisitions. This limitation comes into play when staff authorized to approve purchases are not available. The Agency is currently evaluating a new electronic requisition system that provides for stronger password administration. In the interim, the Agency will develop a procedure for managing the approval process and the use of employees' user ids and passwords. The procedure will be implemented by September 15, 2006.*
- *The system administrator's access to initiate purchase requests in the purchasing system has been removed.*

# Appendices

Appendix 1

## **Objectives, Scope, and Methodology**

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### **Objectives**

The objectives of this audit were to determine:

- Whether purchases are necessary and reasonable and made in accordance with state laws and regulations and Texas Lottery Commission (Agency) rules, policies, and procedures.
- Whether the Agency manages selected contracts to ensure that the contracts are monitored and the terms of these contracts are enforced.
- The status of findings and recommendations related to Agency contracts reported by the State Auditor's Office in *An Audit Report on Management Controls at the Texas Lottery Commission*, SAO Report Number 97-092, August 1997.

### **Scope**

The audit scope included:

- Agency non-contract purchases from December 2004 through May 2006
- The Agency's contracts, controls, and contracting process as of May 2006
- Contractor payments made between May 2005 and May 2006
- Contract deliverables from May 1, 2005, through April 31, 2006, for the Agency's contracts with GTECH Corporation (contract 02-291) and DDB Dallas (contract 03-0230)
- Contract amendments made to the Agency's contracts with GTECH Corporation (contract 02-291) and DDB Dallas (contract 03-0230)

### **Methodology**

The audit methodology included collecting information and documentation, performing selected tests and other procedures, analyzing and evaluating the results of the tests, and conducting interviews with Agency management and staff. Each aspect of contract management that auditors tested was tested with a different sample of contracts.

Information collected and reviewed included the following:

- Agency policies and procedures
- May 2006 Agency contracts
- Fiscal year 2006 active contract list
- Contract files (request for proposal, contract, questions and answers)
- Procurement files
- Requisition information maintained in the Agency's eRequisition system
- Excluded vendors list obtained from the Texas Building and Procurement Commission
- Data obtained from Great Plains, the Agency's accounting system
- Invoice payment files
- Purchase order files
- Reports from the Uniform Statewide Accounting System
- Contractual provisions compliance checklist
- Liquidated damages and sanctions files
- Deliverable reports

Procedures and tests conducted included the following:

- Interviewed Agency executives, division management, staff, and staff of the Agency's contracted vendors
- Compared the Agency's policies and procedures to purchasing laws
- Tested purchase orders against applicable state laws and Agency rules, policies, and procedures
- Compared the Agency's current policies and procedures to all state contracting statutes and the Texas Building and Procurement Commission's *State of Texas Contract Management Guide*
- Performed detailed testing and analysis of selected contracts
- Tested selected contracts for requirements in (1) each phase of contract management in the Texas Building and Procurement Commission's *State of Texas Contract Management Guide* and (2) contracting statutes laws.

The contract management phases in the *State of Texas Contract Management Guide* include:

- ♦ Contract planning
- ♦ Contract procurement
- ♦ Contract formation
- ♦ Rate/price establishment
- ♦ Contract administration and monitoring

Criteria used included the following:

- May 2006 contracts
- Texas Building and Procurement Commission's *State of Texas Contract Management Guide*
- Texas Building and Procurement Commission's *Procurement Manual*
- Title 1, Texas Administrative Code, Chapter 111
- Title 16, Texas Administrative Code, Chapter 401
- Texas Government Code, Chapters 403, 466, 2261, 2262
- Texas Business and Commerce Code, Section 2.207
- Microsoft's SQL Server 2000 C2 Administrator's and User's Security Guide, Chapter 3
- Agency purchasing and contracting policies and procedures

### **Project Information**

Audit fieldwork was conducted from May 2006 through July 2006. This audit was conducted in accordance with generally accepted government auditing standards.

The following members of the State Auditor's staff performed the audit:

- Kels Farmer, CISA (Project Manager)
- Becky Beachy, CIA, CGAP (Assistant Project Manager)
- Wesley Vaughn Hodgin, CPA
- Thomas W. Howe, Jr., MPAff



- Ashlee Jones, MAcy
- Barbette Mays
- Amadou N'gaide, MBA
- Anca Pinchas, MAcy
- Ashley Rutherford
- Sajil Scaria
- Adama Thiam, MBA
- Priscilla Garza (Information Systems Audit Team)
- Gary L. Leach, CQA, CISA, MBA (Information Systems Audit Team)
- Worth Ferguson, CPA (Quality Control Reviewer)
- Michael C. Apperley, CPA (Assistant State Auditor)

## Status of the Agency's Implementation of Prior Audit Recommendations

### Definitions of Implementation Status

- Fully Implemented: Successful development and use of a process, system, or policy to implement a prior recommendation.
- Substantially Implemented: Successful development but inconsistent use of a process, system, or policy to implement a prior recommendation.
- Incomplete/Ongoing: Ongoing development of a process, system, or policy to address a prior recommendation.
- Not Implemented: Lack of a formal process, system, or policy to address a prior recommendation.

Table 4 shows the status of the Texas Lottery Commission's (Agency) implementation of prior State Auditor's Office recommendations.

Table 4

Agency Implementation of Prior State Auditor's Office Recommendations from <i>An Audit Report on Management Controls at the Texas Lottery Commission,</i> SAO Report Number 97-092, August 1997		
Recommendation	Implementation Status	Auditor Comments
The Agency should develop guidelines for vendors specifying the types of information that will be subject to disclosure and should incorporate the guidelines into its contracts, along with sanctions for noncompliance.	Implemented	
The Agency should ensure that it has allocated sufficient internal audit resources (time, coverage, and personnel) to carry out a program of internal auditing as required by the Texas Internal Auditing Act.	Implemented	
The Agency should continue to explore alternatives to the Texas Model that will foster competition and decrease the Lottery's reliance upon a single vendor.	Implemented	Based on a review of the Agency's formal communications for the primary lottery operator procurement, the Agency attempted to foster competition when it: <ul style="list-style-type: none"> <li>▪ Solicited 30 different bidders for its request for information.</li> <li>▪ Requested presentations from five prospective bidders.</li> <li>▪ Received four acceptable letters of intent for its request for proposal. (RFP).</li> </ul> However, the Agency received one acceptable response to its RFP.

**Agency Implementation of Prior State Auditor's Office Recommendations from  
An Audit Report on Management Controls at the Texas Lottery Commission,  
SAO Report Number 97-092, August 1997**

Recommendation	Implementation Status	Auditor Comments
<p>The Agency should complete its plans to create a contract compliance unit. The Agency should also review its contracts with the Lottery Operator and other contractors, identify key compliance areas, and ensure it has adequate procedures to monitor and enforce contract terms.</p>	<p>Incomplete/ Ongoing</p>	<p>The Agency still needs improvement in monitoring contracts. See Chapter 1 for more details. The Agency also has not created a contract compliance unit that ensures that contract monitoring is consistently performed.</p>
<p>We recommend management develop a comprehensive set of policies and procedures that documents the important functions, policies, processes, and steps needed to complete tasks necessary to Agency operations.</p>	<p>Incomplete/ Ongoing</p>	<p>The Agency still lacks certain polices and procedures. Chapter 1 of this report discusses inadequate polices and procedures for negotiations, change management, initiation of contract planning, and developing needs and risk assessments during contract planning.</p>
<p>The Agency should move forward with the proposed financial audit of the Lottery Operator. Supplemental audit work should be performed annually until the Agency determines and obtains the financial information it needs in the Lottery Operator's cost reports to allow the Agency to make informed management decisions.</p>	<p>Incomplete/ Ongoing</p>	<p>The Agency does not actively monitor or analyze the cost of the primary lottery operator contract.</p>
<p>Management should ensure its advertising and promotional contracts comply with the Lottery Act. Management should seek an Attorney General's opinion if it wants to continue advertising at venues that serve alcoholic beverages. The Agency should create a compliance checklist for each type of contract it enters including advertising.</p>	<p>Not Applicable</p>	<p>The Lottery Act (Texas Government Code, Chapter 466) does not restrict the Agency from awarding a contract for a promotional event in venues that serve alcoholic beverages.</p>
<p>The Commission should develop and periodically update a contingency plan that would allow the Agency to quickly and efficiently convert to in-sourcing lottery services. The Agency should also ensure that its staff maintains an in-depth understanding of vendor operations and should draw on this knowledge in developing the contingency plan. The Agency should ensure that it begins the service procurement process early enough so that it will have adequate lead time for approval and start-up if it chooses to in-source lottery services.</p>	<p>Not Implemented</p>	<p>The Agency asserts that it considered options for converting to in-sourced operations in 1997, but the Commission rejected those options at that time. Currently, the Agency has not developed a contingency plan or a business continuity plan to ensure continued lottery operations in the event that the primary lottery operator can no longer provide services. This can be either a plan to continue outsourcing the operations or to bring them in house. It has started to develop a contingency plan but has not completed a draft or implemented a plan.</p>

## Summary of Agency Contracts Tested

Table 5 lists the Texas Lottery Commission (Agency) contracts tested during this audit.

Table 5

Agency Contracts Audited Tested During This Audit				
Contractor and Contract Number	Type of Service	Contract Period	Contract Amount for Fiscal Year 2006	Amended Contract Amount (if applicable)
Davila, Buschhorn & Associates, P.C. (04-9115)	Drawing audit services	July 18, 2003, through August 31, 2005, with two one-year extensions	\$420,000	
DDB Dallas (03-0230)	General market advertising services	October 7, 2002, through October 10, 2004, with two one-year extensions	\$21,100,266	\$32,000,000
Graves, Dougherty, Hearon, & Moody (06-9189)	Outside counsel	January 11, 2006, through August 31, 2006, with a one-year extension	\$300,000 Maximum	\$350,000 Maximum
GTECH Corporation (02-291)	Primary lottery operations and services	October 10, 2001, through August 31, 2007, with four one-year extensions that were immediately executed by the Agency.	\$93,142,490	
M&S Works (06-9144)	Drawing studio and production services	January 1, 2006, through August 31, 2007, with two one-year extensions	\$1,464,636	
Plugged-In (05-9128) (RFO)	Database maintenance	September 17, 2004 through August 31, 2006	\$36,399	
Pollard Banknote Limited (05-9126)	Instant ticket manufacturing and services	September 1, 2004, through August 31, 2007, with five one-year extensions	\$4,900,000	
Randall Eubank (04-9148)	Statistical consulting services	January 28, 2004, through August 31, 2005, with two one-year extensions	\$143,000	
Scientific Games International (05-9125)	Instant ticket manufacturing and services	September 1, 2004, through August 31, 2007, with five one-year extensions	\$11,300,000	

## Summary of Agency Exemptions from Purchasing and Contracting Statutes

Table 6 list the statutes from which the Texas Lottery Commission (Agency) is exempt according to Texas Government Code, Section 466.105.

Table 6

Agency Exemptions from Purchasing and Contracting Statutes		
Texas Government Code Chapter	Chapter Title	Summary
2054	Information Resources	Provides guidance on the acquisition and use of information technology within an agency or university. Specifies powers and duties of the Department of Information Resources.
2151	General Provisions	Transfers powers and duties of the Texas Building and Procurement Commission related to providing telecommunications services to the Department of Information Resources.
2152	Texas Building and Procurement Commission	Specifies commissioner and executive management qualifications and administrative provisions of the Texas Building and Procurement Commission.
2155	Purchasing: General Rules and Procedures	Provides general purchasing process requirements, including proposal solicitations, competitive bidding, best value, small businesses, historically underutilized businesses, posting bid information, and exemptions.
2156	Purchasing Methods	Specifies contract purchase procedures, including public solicitations, bids, awards, rejections, documentation of reasons for award, performance bonds, open market purchases, and competitive sealed proposals.
2157	Purchasing: Purchase of Automated Information Systems	Specifies purchase requirements of automated information systems, including best value, use of catalog purchase, commodity items, competitive sealed proposals, proposal solicitation, awards, and pre-approved terms.
2158	Purchasing: Miscellaneous Provisions for Purchase of Certain Goods and Services	Specifies requirements for purchases of vehicles, electrical items, and contracts for printing laws and recycled products.
2161	Historically Underutilized Business	Specifies procurement requirements relating to historically underutilized business vendors, including good faith efforts, planning and reporting requirements, goals, and the business subcontracting plan.
2162	State Council on Competitive Government	Specifies powers and duties of the State Council on Competitive Government.
2163	Commercially Available Activities	Specifies Texas Building and Procurement Commission requirements for reviewing and determining that the State is getting the best cost for commercially available services.
2165	State Buildings, Grounds, and Property	Specifies Powers and duties of the Texas Building and Procurement Commission, including leases, allocation of space, inspection and maintenance.
2166	Building Construction and Acquisition	Specifies powers and duties of the Texas Building and Procurement Commission, including ownership, acquisitions, disposals, authority, projects, costs, procurement, planning and reporting.

Agency Exemptions from Purchasing and Contracting Statutes		
Texas Government Code Chapter	Chapter Title	Summary
2167	Lease of Space for State Agencies	Specifies powers and duties of the Texas Building and Procurement Commission to lease state-owned space including best value, prerequisites, contracts, noncompliance, and reporting.
2170	Telecommunications Services	Specifies powers and duties of the Department of Information Resources for obtaining telecommunication services, including policies, guidelines, operating procedures, system management, payment, and reporting.
2171	Travel and Vehicle Fleet Services	Specifies powers and duties of the Texas Building and Procurement Commission to obtain travel and vehicle fleet services.
2172	Miscellaneous General Service Provided by Commission	States that that Texas Building and Procurement Commission may provide general services to state agencies including operating a central supply store, maintaining a facility for repairing office machines, assisting with agency printing activities, storing and displaying the archives of Texas, and soliciting and accepting private donation for specific purpose.
2175	Surplus and Salvage Property	Specifies powers and duties of the Texas Building and Procurement Commission in administrating personal property that exceeds a state agency's needs and is not required for the agency's foreseeable needs.
2176	Mail	Specifies powers and duties of the Texas Building and Procurement Commission in conjunction with the U.S. Postal Service to evaluate state agencies' mail operations.
2177	Electronic Commerce	Specifies Texas Building and Procurement Commission requirements related to accessibility to the electronic commerce opportunities and procurement marketplace and participation in the electronic commerce network.
2254	Professional and Consulting Services	Specifies procurement process requirements for services classified as professional or consulting.

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The Honorable Jim Keffer, House Ways and Means Committee

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The Honorable Rick Perry, Governor

### **Texas Lottery Commission**

Members of the Texas Lottery Commission  
    Mr. C. Thomas Clowe, Jr., Chairman  
    Mr. James A. Cox, Jr.  
Mr. Anthony Sadberry, Executive Director



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